

Outline of Observations by
DAN M. GUY, PhD, CPA
Before the Advisory Committee on the Auditing Profession
Panel on Firm Structure and Finances
US Department of the Treasury
Draft Report dated May 5, 2008
Presented on June 3, 2008
Washington, DC

I. Background

A. AICPA

Over 18 years at AICPA as Director of Auditing Research; Vice President, Auditing; and Vice President, Professional Standards and Services. Early retirement from AICPA in 1998. Throughout AICPA employment had responsibility for auditing standards.

B. Litigation Consulting Practice

Litigation consulting practice for last 10 years in Santa Fe, NM, primarily involving accountants' malpractice. Engaged as an expert on both plaintiff and defendant sides, including work for and against large CPA firms and work for and against SEC. Have testified in over 12 cases and worked on numerous cases involving allegations of fraud and illegal acts, including a number of cases that are household names. (Summary resume attached.)

C. Practice Philosophy

I do not accept marginal plaintiff cases involving auditor defendants, but I do accept cases against auditors when their level of performance is grossly substandard. I sometimes refer to those audits as drive-by-audits in that the auditor has no basis to support the audit opinion issued on the company's financial statements.

II. Draft Report Recommendations

I applaud your draft report recommendations to (A) create a national center to facilitate the development of best practices related to fraud prevention and detection, and (B) clarify the existing audit report to better communicate the auditor's responsibility for financial statement fraud. Concerning the latter, I recommend that you expand the recommendation to include illegal acts. The current audit report language related to whether the financial statements are free of material misstatements includes material error, fraud, and direct effect material acts, but does not explicitly so state.

III. Observations about Fraud based on Litigation Experience

In my opinion, the audit failures today that have resulted in and will result in suits against auditors are caused by performance failures in extant standards. In other words, I have rarely identified an auditing issue involving litigation when I have concluded that auditing standards are deficient. The few exceptions to that I have encountered relate to deficiencies in audit documentation, which are now appropriately addressed in PCAOB Auditing Standard No. 3, "Audit Documentation," and AU 722, "Interim Financial Information," which although last revised in 2002, still misses the mark.

Concerning audit documentation or audit work papers, a number of the cases that I have worked on and that I am working on today, all after Enron, involved destruction or alteration of audit work papers. Instead of explicitly addressing unlawful work paper destruction or alteration, which strikes at the heart of the auditing profession's integrity, in new or revised ethical or auditing standards, perhaps, the matter is best left up to courts for resolution and punishment.

The following observations are based on my litigation experience based of hundreds of hours of work per case and the issuance of over 20 expert reports on the application of auditing standards to fraud related cases.

In my experience, the most significant reasons that auditors fail to detect material financial statement fraud is that auditors:

- Fail to exercise professional skepticism as mandated in AU 230, “Due Professional Care in the Performance of Work.”
- Assume that management has unquestioned honest and accepting less than persuasive audit evidence because of that belief.
- Fail to recognize, document, and respond to fraud risk factors or red flags that are set out in AU 316, “Consideration of Fraud in a Financial Statement Audit.”
- Over rely on management representations without obtaining, as required by AU 333, “Management Representations,” competent supporting audit evidence.
- Over rely on PBCs (documents prepared by client) as audit evidence without sufficient testing to underlying books and records.
- Over rely on inquiry to client personnel as a form of audit evidence.
- Use electronic and written audit programs and other audit-firm produced checklists in a mechanical or rote manner with almost a “fill-in-the-blank” mindset.
- Fail to understand GAAP and properly apply GAAP to client facts and circumstances that govern material transactions and account balances.
- Fail to maintain independence and to avoid conflicts of interest because of a lack of recognition of ethical issues and how to resolve those issues.

Finally, concerning the auditor’s responsibility to detect fraud, after numerous attempts to clearly state in auditing standards that the auditor has a responsibility to design and perform the audit to detect material fraud (including direct effect illegal acts), many auditors still disavow that responsibility. Unfortunately, these gross misunderstandings are frequently presented in expert testimony before juries. To illustrate, in one of the largest audit fraud cases in US history, I recently had to address a statement by a highly paid expert that auditing standards were not

designed to detect collusive management fraud. Of course, that contradicts AU 316 (both current and prior versions) and, if the statement were true, audits performed by CPAs would be worthless.

IV. Conclusions

An auditing standard on fraud must be frequently revisited to determine what's working and what's not in terms of how the standard is being implemented in practice. In addition, such standard has to be supported by an unfettered sharing of experiences to facilitate the development of best and leading edge practices. Consequently, it is reasonable to expect that in order to maintain an evergreen auditing standard on fraud, that standard will need to be frequently amended. To ensure that those events take place, the draft report recommendation for the establishment of a national center on fraud prevention and detection should be implemented.

The implementation of a national center on fraud prevention and detection will in and of itself not bring about significant improvement in auditor performance concerning fraud and illegal acts without, as discussed above, significant improvements in the implementation of other auditing standards, along with considerable improvements in accounting education, auditor training, and other recommendations made in the draft report about human capital.

Resume of Dan M. Guy, Ph.D., CPA

Dan M. Guy lives and practices in Santa Fe, New Mexico. Dan's practice is limited to consulting services, including litigation involving (1) accountant's ethical responsibilities and malpractice issues related to audit, attest, review, and compilation services and (2) issues relating to duties and responsibilities of audit committees. He is a member of the American Institute of CPAs (AICPA), the Texas Society of CPAs, New Mexico Society of CPAs, and the National Association of Corporate Directors.

Dan completed an 18-year career with the AICPA in New York City in January 1998, a career that culminated with responsibility for Accounting Standards, Auditing and Attest Standards, Compilation and Review Standards, Technical Information Hotline, the PCPS's Technical Issues Committee, and International Accounting and Auditing Standards.

Dan joined the AICPA as Director of Auditing Research in 1979, became Vice President-Auditing in 1983, and Vice President-Professional Standards and Services in 1996. Before that, he was a visiting professor of accounting at the University of Texas at Austin and a professor of accounting at Texas Tech University in Lubbock.

During Dan's tenure as Vice President, the AICPA issued more than 40 Statements on Auditing Standards, eight of the original Statements on Standards for Attestation Engagements, and one Statement on Standards for Accounting and Review Services. Dan also developed the AICPA's Auditing Practices Release series, the audit risk alerts, the compilation and review alerts, and the concept of "user-friendly standard setting," as evidenced by the nonauthoritative wrap-around material he developed to help CPAs implement SAS No. 82, "Consideration of Fraud in a Financial Statement Audit."

He has published over 50 articles, 13 continuing education courses for CPAs, 11 books, including (1) *Audit Committees: A Guide for Directors, Management, and Consultants* (Aspen Law & Business), (2) *Practitioner's Guide to GAAS* (Wiley), (3) *Ethics for CPAs: Meeting Expectations in Challenging Times* (Wiley), (4) *Guide to International Auditing and Related Services* (PPC), (5) *The Auditor's SAS Field Guide* (Wiley), (6) *Practitioner's Guide to Audit Sampling* (Wiley), (7) an auditing textbook in its 5th edition (Dryden), and (8) a widely-used reference manual, *Guide to Compilation and Review Engagements* (PPC), now in its 28th edition. He has developed web-based materials on (1) the "e-Guide to Independence

Requirements,” (2) “Independence: Beyond the Rules,” and (3) “Independence for Higher Education” for a large international accounting firm under an SEC decree.

In 1998, Dan received the John J. McCloy Award for outstanding contributions to auditing quality in the United States. The annual award was presented by the Public Oversight Board. The POB was an independent, private sector body that monitored and reported on the self-regulatory programs and activities of the SEC Practice Section of the Division for CPA Firms of the AICPA. In 2001, Dan received the Distinguished Service Award from the Auditing Section of the American Accounting Association for a lasting and significant impact over a 20 to 25 year span in the field of auditing.

Dan holds B.A. (1965) and M.B.A. (1967) degrees from East Carolina University in Greenville, NC and a Ph.D. (1971) from the University of Alabama at Tuscaloosa (where he was an Arthur Andersen Doctoral Dissertation Fellow). In 1995, he was awarded the Outstanding Alumnus at East Carolina University. He is a Texas CPA and was in public practice with KPMG (Peat Marwick) in Greensboro, NC.

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